BEFORE THE
PUBLIC SERVICE COMMISSION OF WISCONSIN

INVESTIGATION INTO AMERITECH WISCONSIN'S UNBUNDLED NETWORK ELEMENTS	))))	DOCKET NO. 6720-TI-161

CLECS' INITIAL BRIEF ON SHARED AND COMMON COSTS

AT&T Communications of Wisconsin, L.P., WorldCom, Inc., KMC Telecom, Inc., McLeodUSA Telecommunications Services, Inc., Rhythms Links, Inc., TDS Metrocom, Inc., and Time Warner Telecom of Wisconsin, L.P. (hereinafter the "CLECs"), by their counsel, submit their initial brief on shared and common cost issues. [1]

Ameritech's shared and common cost study is fundamentally flawed. The net effect of these flaws, not surprisingly, is to increase Ameritech's Overhead Expense Loading and, ultimately, the rates Ameritech charges CLECs for unbundled network elements (UNEs). The CLECs' witness Brad Behounek is very familiar with Ameritech's shared and common cost models, having analyzed the models in painstaking detail in multiple regulatory proceedings. Based on his thorough analysis, he recommends a number of adjustments and corrections to Ameritech's model.

Legal Framework

[1] In this brief, the CLECs address the issues set forth in Section I. B (2) of the post-hearing Issues List. The phrase "shared and common costs" is often used interchangeably with the phrase "joint and common costs," with no substantive distinction intended. For consistency purposes, the CLECs use "shared and common costs" throughout this brief.

Legal Framework

When viewed in the proper legal framework, the flaws in Ameritech's shared and common cost study are glaring. The FCC Order in CC Docket 96-98 (the "FCC Order")[2] contains language addressing both the nature of the shared and common costs to be calculated and the method to be used for allocation.

Regarding the type of joint and common costs to be calculated, the FCC Order states at paragraph 694 that "[b]ecause forward-looking common costs are consistent with our forward-looking, economic cost paradigm, a reasonable measure of such costs shall be included in the prices for interconnection and access to network elements." (emphasis supplied).[3] The FCC's use of "forward-looking," therefore, relates to its economic cost paradigm. In 47 CFR §51.505(c)(1), the FCC defines forward-looking common costs as "economic costs, efficiently incurred in providing a group of elements or services." (emphasis supplied). In paragraph 679, in describing TELRIC methodology, the FCC Order states that "[a]dopting a pricing methodology based on forward-looking, economic costs best replicates, to the extent possible, the conditions of a competitive market." It continues: "Because a pricing methodology based on forward-looking costs simulates the conditions in a competitive marketplace, it allows the requesting carrier to produce efficiently and to compete effectively, which should drive retail prices to their competitive levels."

[2] The FCC's First Report and Order in CC Docket Nos. 96-98 and 95-185, In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, August 8, 1996.

[3] ¶ 694 states that a reasonable measure of common costs "shall be included in … prices." (emphasis supplied). However, ¶ 620 of the FCC Order indicates that the states "may set prices to permit recovery of a reasonable share of forward-looking joint and common costs of network elements." (emphasis supplied). The FCC appears to have intended that the amount, if any, of joint and common costs to be included in prices may vary depending on specific circumstances. For example, if unbundled network elements have difficulty passing an imputation test, a reduced allocation of joint and common costs may well be appropriate.

The FCC Order also points out that "the network elements, as we have defined them, largely correspond to distinct network facilities. Therefore, the amount of joint and common costs that must be allocated among separate offerings is likely to be much smaller using a TELRIC methodology rather than a TSLRIC approach that measures the costs of conventional services."[4]

With regard to the allocation method to be used for shared and common costs, the FCC Order states that "[o]ne reasonable allocation method would be to allocate common costs using a fixed allocator, such as a percentage markup over the directly attributable forward-looking costs."[5] The FCC Order continues, however, by stating that "[w]e conclude that a second reasonable allocation method would allocate only a relatively small share of common costs to certain critical network elements, such as the local loop and collocation, that are most difficult for entrants to replicate promptly (i.e., bottleneck facilities). Allocation of common costs on this basis ensures that the prices of network elements that are least likely to be subject to competition are not artificially inflated by a large allocation of common costs."[6] Thus, the FCC Order requires that shared and common costs be attributed to the group of elements causing the costs to be incurred.

Summary of Conclusions

The critical problems with Ameritech's shared and common cost study, along with Mr. Behounek's recommended adjustments, can be summarized as follows.

1. Unlike the more appropriate bottom-up methodology employed in its Long Run Incremental Cost ("LRIC") studies, Ameritech's shared and common cost study

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[4] FCC Order, ¶ 678 (footnote omitted).

[5] Id., ¶ 696.

[6] Id., ¶ 696.

represents a top-down approach that provides little incentive for Ameritech to identify costs that are inappropriate for inclusion in its cost analysis. Ameritech's top-down approach also requires parties to attempt to identify inappropriate costs that are hidden within broad expense categories, which further make it more likely that these costs will remain among the shared and common costs.

2. Ameritech's shared and common cost study is based on both regulated and non-regulated cost data even though Ameritech only produces LRIC studies for regulated services (and actually, only a subset of these). Therefore, there are no cost studies for non-regulated services to which parties can look in order to determine that the costs for these services are not also included in the shared and common costs. Therefore, Ameritech should use only its regulated expense accounts.

3. Ameritech's shared and common cost study neglects to take network growth into account. While Ameritech attempts to determine the future replacement cost for its current plant it neglects the fact that its plant investment will also increase over time. This results in an understatement of the expenses that comprise the denominator for the shared and common cost mark-up calculation, which, in turn, overstates the shared and common cost mark-up. CLEC witness Brad Behounek provided a forecast of the expected plant growth from 1998 to 2001 and incorporated it into the study.

4. Within its shared and common cost study, Ameritech relies on its 1998 investments and expenses without making any adjustment to reflect efficient operations. Ameritech currently operates in a predominately non-competitive environment and has thus not been subjected to the disciplining effect of real competition. Therefore, in order to make Ameritech's shared and common costs reflective of a forward-looking, most-

efficient operation, Mr. Behounek employed a 24% reduction in Ameritech's overhead costs. (*See,* Tr. Vol. 8, p. 2850, 2851.) This 24% reduction is based on the experience of AT&T, a telecommunications company that went from a monopoly to competitive environment.

5. Ameritech double counts its Plant Operations Administration and Engineering expenses. That is, these expenses are found in both the LRIC studies and the shared and common cost study. Mr. Behounek recommends that Ameritech allocate these expenses between the LRIC and shared and common cost pools in the same proportion that Network Administration (another Network Support expense account) is allocated.

6. Ameritech misallocates Product Support costs between its wholesale and retail operations. That is, wholesale operations receive a disproportionate amount of these costs in comparison to retail operations. This skewed allocation results in an overstated Wholesale Factor by approximately 27%. Wholesale services commonly, and by their nature, generate fewer overhead costs (such as product support, sales, marketing, etc.) per unit than their retail counterpart. Therefore, one would expect the Product Support cost to be less per unit for wholesale service versus retail service. Further, the 1996 Act and the resultant FCC rules explicitly recognize that wholesale costs should be lower than retail costs through their requirement that avoided costs be removed when determining wholesale rates.

7. Ameritech improperly includes Legal and External Relations costs in its shared and common costs. Anyone present in the hearing room on a daily basis to observe the excesses (e.g., 7-10 attorneys, 2-3 legal assistants, 2-3 subject matter experts per witness, numerous management observers) SBC-Ameritech brought to bear on this proceeding

would have to agree that CLECs should not be required to underwrite Ameritech's efforts against them. Therefore, the CLECs recommend that Ameritech remove these inflated costs from its shared and common cost pool.

Based on the compelling evidence in the record, the Commission should set Ameritech's Overhead Expense Loading at *** (*See* Tr. Vol. 9, p. 3019 and Vol. 11, p. 4349, Exh. 69.)

I. AMERITECH'S SHARED AND COMMON COST STUDY IS FLAWED AND MUST BE REVISED.

A. Ameritech's Study Uses a Top-Down Methodology and is Based on Both Regulated and Non-Regulated Cost Data.

Since Ameritech has not performed LRIC cost studies for its non-regulated services it would be impossible to assure that costs associated with non-regulated services do not appear in the shared and common cost pool. Indeed, the record indicates that Ameritech's non-regulated costs are currently reflected in the shared and common cost pool in various services.

Ameritech offers unregulated services such as Debit Card, Digital Network Channel Terminating Equipment, Enhanced FAX Services, Inside Wire, Incidental InterLATA Services, Payphone Equipment, Professional Services, Protocol Conversion, Sales, Installation and Maintenance of Customer Premises Equipment, Software Sales, Voice Messaging Services, among others. Without LRIC studies for these services, it cannot be determined whether services such as these are excluded from the USOA accounts identified by Ameritech as shared and common.

"Professional Services" is but one example of how the costs for these services are included in the USOA accounts that Ameritech identifies as shared and common. Ameritech's cost allocation manual describes Professional Services as involving the marketing of an array of professional (e.g., legal, tax, marketing, human resources, etc.) services provided by third party vendors as well as those developed internally. These are non-regulated services. If the Commission were to examine these services, it is likely it would find that the direct costs (i.e., LRICs) for these services would be found in the Legal, Accounting and Finance, and Human Resources USOA accounts. As it now stands, however, all of the costs in these accounts are being allocated to all of the services, the direct costs of which were actually studied. Therefore, the costs of professional services are being recovered directly from the third parties receiving the services and the costs are being recovered again when these costs are allocated to the studied services. This double counting inflates Ameritech's shared and common costs.

"Software Sales" is another example. Ameritech's cost allocation manual defines these services as follows: "Non-regulated Software Sales includes software either purchased for resale or internally developed for sale to nonaffiliated third parties." As Mr. Behounek testified, the development of software sounds suspiciously like activities that are described in Account 6724, which Ameritech, in total, allocates through the Overhead Expense Loading to the services the direct costs of which it did study. Further, Ameritech failed to study or disclose the extent to which software sales incur Product Management (USOA 6611), Sales (USOA 6612), Product Advertising (USOA 6613), and Customer Services (USOA 6623) expenses. As Mr. Behounek observed, software generally requires significant customer service and should pick up its own share of shared and common costs. (*See* Tr. Vol. 8, p. 2843)

Ameritech did not study the above services, among other, non-regulated services. Indeed, Ameritech made no attempt to identify whether there are direct costs associated with providing the services that are associated with the accounts that it classifies as shared and common. Therefore, as Mr. Behounek concluded, the best alternative is for Ameritech to use only the regulated USOA balances found in the ARMIS 43-03 report as the starting point for its shared and common costs study. (*See* Tr. Vol. 8, p. 2843)

In Michigan Case No. U-11831, CLEC witness Mr. Behounek made a recommendation to the Michigan Public Service Commission (MPSC) that was substantially the same as that made in this proceeding. Ameritech opposed the use of the regulated account totals in Michigan, stating that the costs allocated to non-regulated services reflected in the ARMIS 43-03 are not TSLRIC-based cost allocations. However, USOA account balances in general are not TSLRIC-based. Ameritech's criticism applies with equal force to the USOA cost data that <u>is</u> the basis for Ameritech's study in the first place. That is, if allocations between regulated and non-regulated services are invalid because they are not TSLRIC/TELRIC based, then the USOA account information upon which Ameritech's study is based must be invalid also. Relying on Mr. Behounek's analysis and recommendations, the MPSC rejected Ameritech's shared and common cost study, essentially the same study Ameritech is presenting to the Commission here. (*See* Tr. Vol. 8, p. 2844)

Here, Ameritech's 43-03 ARMIS report identifies non-regulated expenses in the accounts that Ameritech identifies as exclusively shared and common. For example, about 13% of the costs associated with the Executive, Human Resources, and Information Management USOAs, which Ameritech attributes exclusively to its shared and common cost pool, relates to non-regulated services. The use of regulated-only ARMIS data cost pools has the effect of reducing Ameritech's shared and common or Wholesale Overhead Expense Loading Factor from *** (*See* Tr. Vol. 9, p. 2980.)

Ameritech's inappropriate use of non-regulated versus the combined regulated/non-regulated USOA data inflates the shared and common cost percentage. Ultimately, FCC rules govern the regulated and non-regulated USOA account data that Ameritech uses. FCC rules also govern the separating of data between regulated and non-regulated services. Further, the FCC requires both direct apportionment of costs and allocations of costs to generate both the total USOA account data and the split between the regulated and non-regulated. As Mr. Behounek determined, because substituting regulated data for the regulated/non-regulated combined data results in the decrease of Ameritech's shared and common costs, it is clear that certain of the accounts that Ameritech portrays as shared and common contain costs that are direct costs for some of its unregulated services. (*See* Tr. Vol. 8, p. 2845)

B. Ameritech's Shared and Common Cost Study Fails to Account for Investment Growth.

Ameritech's shared and common cost study inexplicably fails to forecast Ameritech's investment growth. In its shared and common cost study, Ameritech attempts to forecast certain expenses in order to determine what its expenses would be in 2001. However, Ameritech does not do this for investment-related expenses. That is, while Ameritech attempts to determine the replacement cost of its 1998 investment in 2001 through the application of current-cost-to-booked-cost ratios and telephone plant indices, it does not adjust for the fact that Ameritech would also add plant as its network grows. Currently, within Ameritech's shared and common cost study, certain costs (the bulk of which are shared and common costs) are forecasted forward while investment-related expenses (the bulk of which are LRIC-related) are not. This has the effect of overstating Ameritech's shared and common cost mark-up.[7]

Further, Ameritech's current-cost-to-booked-cost ratios and telephone plant indices (TPIs) do not account for the investment growth related to the growing network. At page 22 of the "Ameritech Shared & Common Cost Factors Model Documentation and User Manual," Ameritech states "The TPI worksheet (Schedule 10) contains the information used to adjust base year investments for inflation." (*See* Tr. Vol. 8, p. 2847) As this quote demonstrates, TPIs are used to adjust plant balances for inflation, and since the Current-Cost-to-Booked-Cost ratios are derived based on TPIs they also do no more than adjust for inflation.

To account for the fact that Ameritech does not adjust for the effects of a growing network, Mr. Behounek proposes adjusting the regulated plant balances by applying a 4.54% decrease for Land and Support investment and applying a 12.31% increase for non-Land and Support investment. Using ARMIS data from 1992 through 1999, Mr. Behounek forecast both Land and Support Investment (primarily shared and common

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[7] The shared and common cost mark-up increases because the denominator used to determine the shared and common cost mark-up contains investment-related expenses associated with the network (e.g., poles, conduit, cable, switches, electronics, central offices, etc.). If these investments are understated, then their corresponding expenses are understated. This flaw, in turn, understated the denominator used to calculate the shared and common cost mark-up, which results in an overstatement of the shared and common cost mark-up.

costs in Ameritech's study) and non-Land and Support assets (primarily LRIC costs in Ameritech's study). The forecast demonstrated an expected 4.54% decrease in Land and Support investment from 1998 to 2001 and an expected 12.31% increase in non-Land and Support investment during the same period. This adjustment, along with the previously recommended adjustments, has the effect of reducing Ameritech's Wholesale Factor from *** (*See* Tr. Vol. 9, p. 2982, 2983.)

C. Ameritech's Shared and Common Cost Study Fails to Account for a Forward Looking, Efficient Network.

As the record supports, Ameritech has not made any adjustments in its shared and common cost study to reflect a, forward looking, most efficient network. Ultimately, Ameritech has made no attempt to demonstrate whether or not the shared and common costs it analyzed result from an efficient operation. Ameritech's study simply is based on the company's existing booked and embedded costs as reported in its ARMIS reports. While there are attempts to adjust Ameritech's embedded costs, these adjustments are based on the existing operations - - efficient or not - - and thus do not make the costs forward looking.

Even Ameritech would admit that its investments and expenses are not as efficient as they would be if it were operating in a competitive market. The bottom line is that Ameritech conducted no analysis to demonstrate that its shared and common costs result from an efficient operation. The adjustments it did make are based on attempts to determine the equivalent current cost of Ameritech's historical investments, a trending of certain cost pools, and the use of a forward-looking cost-of-money and forward-looking economic lives. But the forward-looking cost of money and economic lives have nothing to do with whether Ameritech's operations are currently efficient. The equivalent current costs of Ameritech's investment (and the trending of those costs) start with Ameritech's existing embedded investments and costs without regard to whether Ameritech is operating efficiently.

In Michigan, AT&T recommended that Ameritech's forecasted cost savings and inflation methodology be replaced by a simple 10% across-the-board reduction to the actual account balances that comprise the shared and common cost pool, because Ameritech's adjustment methodology is not forward looking and was (and still is) flawed and did not (and still does not) sufficiently adjust Ameritech's costs to make them more forward-looking. Ameritech challenged the 10% reduction as arbitrary, even though it made no attempt itself within its shared and common cost study to make the study reflective of a forward-looking, most-efficient operation. In point of fact, the 10% adjustment was a conservative estimate made in the Michigan proceeding due to the lack of a specific benchmark. Mr. Behounek testified that he has since found a relevant benchmark, AT&T, and recommends that Ameritech reduce its shared and common costs by 24% in order to better reflect forward-looking, most-efficient operations.

AT&T found that in its transition from a monopoly provider to competitor it needed to reduce its overhead by at least 24% to be efficient. Ameritech will likely be making a similar transition some day and will have to reduce its own overhead by at least a similar amount to be efficient and competitive.[8] Although Ameritech's and AT&T's

[8] See AT&T Annual Report, 1999, p. 12 ("In order to become truly competitive, we must become the low-cost provider in the industry, and therefore, we are continuing our efforts to reduce our cost structure. A year ago, we committed to reducing our 1999 selling, general and administrative (SG&A) expenses to 23% of revenue. We beat that target, delivering an SG&A expense-to-revenue ratio of 21.7% for the year,

overhead percentages cannot be compared directly, the fact remains that AT&T believed it must shrink its overhead by an additional 24%. AT&T's experience demonstrates that Ameritech has not yet begun to achieve the efficiencies that will be required by the emergence of real competition in the local services market.

As Mr. Behounek concluded, Ameritech's cost study must be adjusted to set the cost savings percentage to 24% and the inflation setting to 0%. He relied on the fact that AT&T found that it must reduce costs by 24% to be efficient, and did so without an adjustment for inflation. Mr. Behounek's adjustment, along with his previously recommended adjustments, has the effect of reducing Ameritech's Wholesale Factor from *** (*See* Tr. Vol. 9, p. 2986.)

D. Ameritech's Shared and Common Cost Study is Flawed in that It Double Counts Plant Operations and Engineering Expenses.

Yet another problem with Ameritech's shared and common cost study is the manner in which Ameritech treats plant operations administration (USOA 6534) and engineering (USOA 6535) expenses. In short, Ameritech allocates the entirety of these expense accounts to the shared and common cost pool, while costs related to these accounts permeate the LRIC cost studies. Ameritech thus double counts plant operations and engineering expenses.

To fully understand Ameritech's errors, it is important to understand how these accounts (USOAs 6534 and 6535) work. First, the FCC's Part 32 rules for these accounts

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which translates into approximately $830 million of SG&A expense savings compared with our targets. The fourth quarter came in at just 21.2%. That's a dramatic improvement from 1997, when the SG&A expense-to-revenue ratio for the year was 27.9%. While we've been successful in driving costs out of the business, we still have more to do.")

clearly indicate that accounts 6534 and 6535 must only contain costs of an administrative nature. In addition, the Part 32 rules clearly define accounts 6534 and 6535 as clearance accounts. Because these are clearance accounts, costs are booked to the accounts throughout the year. During the year, the individuals whose costs are booked to these accounts perform functions for various parts of the company. For example, individuals whose expenses are originally booked to account 6535-Engineering may do some switch-related engineering. Some switch-related engineering costs may be taken out of account 6535 and booked (cleared) to account 2212 (the switching investment account). If the underlying services are not the type that would be booked to the investment account (say for maintenance or similar activities) these costs will be booked (cleared) to the plant-specific switching account (6212) from account 6535. The same general thing happens with account 6534-Plant Operations Administration. The net balances (after clearances) of accounts 6534 and 6535 are the expenses that Ameritech allocates to its shared and common costs. This, however, is problematic, for a few reasons.

Ameritech erroneously includes only the net balances for Plant Operations Administration and Engineering in its shared and common costs. First, it should be understood that the expenses cleared from the Plant Operations Administration and Engineering accounts are included in the LRIC studies. Specifically, the amounts cleared to the investment account (2212) are the types of costs that are added to investment in the LRIC studies through items such as the engineered, furnished, and installed costs added on to investment. Thus, these cleared amounts find their way into the LRIC studies. The amounts cleared to the plant specific accounts such as account 6212 (Digital Electronic Switching) also find their way into the LRIC studies because these accounts make up the majority of expenses from which the maintenance factors are calculated. The only portion of the plant specific accounts, which contain cleared amounts from accounts 6534 and 6535, and which do not become part of the maintenance factors, are the costs associated with the following forces (related activity code is supplied):

(a) **LAC (Activity Codes 4000 and 4003)**

(b) **SOEC (Activity Code 2330)**

(c) **CMC (Activity Code unknown)**

(d) **CP&M (Activity Codes 4100, 4103, 4230, 4239)**

Ultimately, Ameritech has included the entirety of the uncleared amounts of accounts 6534 and 6535 in the shared and common costs. Further, the cleared amounts become part of the engineered, furnished, and installed costs, or the maintenance factors (except for the costs related to the activity codes listed above). Therefore, as Mr. Behounek testified, if there are any activity codes relating to accounts 6534 and 6535 found in the LRIC studies that are not among those listed above, then there is a double count. (*See* Tr. Vol. 8, p. 2854)

Ameritech's treatment of engineering and plant operations administration expenses results in such a double counting in its costs studies. Mr. Behounek's review of Ameritech's LRIC studies in this docket has revealed many instances of such double counting. Ultimately, two things may be occurring with the costs in these accounts: (1) the costs are being double-counted in the LRIC studies; or (2) the costs are being included in both the LRICs and the shared and common costs. If the double counts are in the LRICs, the result is that the same costs are being recovered in the recurring charges through the maintenance factors as are being recovered through items such as nonrecurring charges. Mr. Behounek assumed, however, that the double-count is occurring between the shared and common costs and the LRICs.

To eliminate the double counting problem in Michigan, AT&T recommended that the same portion of expenses that are allocated to the LRIC cost pool for account 6532—Network Administration, which is also a Network Support expense, be used for accounts 6534 and 6535. That is, if *** of Network Administration is allocated to the LRIC pool in the shared and common cost study (which it is) with the remainder being allocated to overhead, then the same should be done for the other Network Support expenses (Plant Operations Administration and Engineering). (*See* Tr. Vol. 9, p. 2990.) Ameritech never directly refuted AT&T's adjustment proposal to eliminate the double counting of expenses. Ameritech simply discussed at great length that accounts 6534 and 6535 contain only administrative level costs, and are clearance accounts. Ameritech contended that different treatments were necessary because accounts 6534 and 6535 are clearance accounts and 6532 (Network Administration) was not. Interestingly, Ameritech never discussed what that different treatment should be. Therefore, the same portion of expenses that are allocated to the LRIC cost pool for account 6532—Network Administration, which is also a Network Support expense, should be used for accounts 6534 and 6535. This adjustment, after the previously recommended adjustments, has the effect of reducing Ameritech's Wholesale Factor from *** (*See* Tr. Vol. 9, p. 2991.)

E. Ameritech Misallocates Product Support Costs Between Its Wholesale and Retail Operations.

Ameritech's shared and common cost study also suffers from an inappropriate allocation of product support costs between wholesale and retail operations. This improper allocation results in an overstated Wholesale Factor by approximately 27%. Ameritech's Product Support costs include the Product Management, Sales, and Uncollectibles categories and their allocations between retail and wholesale are way out of line, according to Mr. Behounek's analysis. The only Product Support category that appears to be in line is that for Product Advertising where *** is applied to retail and *** is applied to wholesale *** (*See* Tr. Vol. 9, p. 2991.)

The Product Management, Sales, and Uncollectibles categories, when combined and as presented in Ameritech's shared and common study, produce a retail/wholesale split of *** (*See* Tr. Vol. 9, p. 2991.) Ameritech's allocation of these Product Support expenses is out of line with the quantity of product sold. For example, in data from June 1999, Ameritech-Wisconsin was shown to serve over 2.1 million residential and business access lines; yet the number of unbundled loops Ameritech-Wisconsin served was only about 19,000 or less than 1% of that. Nevertheless, Ameritech split the Product Support categories by the aforementioned *** retail wholesale allocation. (*See* Tr. Vol. 9, p. 2991.)

Moreover, Mr. Behounek explained that the expense split should not be equal to the split between units sold. Wholesale services commonly, and by their nature, generate fewer overhead costs (such as product support, sales, marketing, etc.) per unit than their retail counterpart. This is why customers are invited to "buy wholesale and save." Therefore, one would expect the Product Support cost to be less per unit for wholesale service versus retail service. Further, the 1996 Act and the resultant FCC rules explicitly recognize that wholesale costs should be lower than retail costs through their requirement that avoided costs be removed when determining wholesale rates.

For the above reasons, Ameritech's product management costs should be, but are not, lower for wholesale versus retail services. Ameritech's lopsided allocation is particularly curious given the general description of the Product Management account. The FCC's description of USOA account 6611 is as follows:

> This account shall include cost incurred in performing administrative activities related to marketing products and services. This includes competitive analysis, product and service identification and specification, test market planning, demand forecasting, product life cycle analysis, and identification and establishment of distribution channels.

On their face these activities relate more to retail services then wholesale services. Mr. Behounek added that he was unaware of any other companies offering unbundled elements in Ameritech's service territory, so it is unlikely that Ameritech Information Industry Services (AIIS) – the wholesale unit that sells UNES - would be performing "competitive analyses". Regarding "administrative activities relating to marketing products and services," Ameritech's wholesale services should not require any marketing, as there are no alternative sources for unbundled elements. (*See,* Tr. Vol. 8, p. 2858)

Similarly, Ameritech's sales costs should be lower for wholesale versus retail services. Consider a retail versus wholesale transaction. In the retail environment, for a typical sale, Ameritech personnel have to identify and contact potential customers individually; record the customer's personal information; determine the customer's needs; persuade and convince the customer to buy additional services; and then determine how to best configure the ordered services. In contrast, in the wholesale environment the customers are either more sophisticated and already know exactly what they need, or in the case of unbundled elements, the recording, determining, convincing, and configuring has already taken place by the CLEC.

Further, CLECs are put at a competitive disadvantage because of these unreasonably high Product Support expenses charged by Ameritech. CLECs will incur their own product support expenses as a result of their retail sales efforts. It is very difficult for CLECs to price their services competitively if they must recover their own legitimate retail product support expenses, and also try to recover the unreasonably high wholesale product support charges imposed by Ameritech.

Whatever the reason or motivation, there is no denying that Ameritech has skewed its allocation of Product Support Expenses. To remedy this problem, Mr. Behounek recommends a very conservative 5% / 95% split, respectively, for wholesale and retail operations in Ameritech's Product Management, Sales, and Uncollectibles expense categories. (*See* Tr. Vol. 8, p. 2864) This split is conservative for two reasons: (1) unbundled services are highly unlikely to comprise more than 5% of the products Ameritech sells, and (2) the characteristics of wholesale services dictate that these services should have relatively lower costs of these types.

The effect of Mr. Behounek's proposed adjustment of Ameritech's Product Management, Sales, and Uncollectible expenses, in combination with the previously recommended adjustments, is to reduce Ameritech's Wholesale Factor 23%, from ***. (*See* Tr. Vol. 9, p. 2995.)

F. Ameritech Inappropriately Includes Legal and External Relations Costs In Its Shared and Common Cost Model.

Ameritech inappropriately includes legal and external relations costs in the shared and common cost pool. Ameritech, in the legal and regulatory arenas, and through its attempts to influence decision makers through lobbying and external relations, takes positions that are often flatly contrary to the interests of the CLECs. If these costs are included in the shared and common cost pool, then CLECs are helping to finance Ameritech's efforts to thwart their competitive entry. Permitting Ameritech to recover these costs through unbundled elements forces the CLECs to underwrite Ameritech's efforts against them. Assuming it will recoup its legal and regulatory expenses though rates charged to CLECs, Ameritech has every incentive to out-spend its competition in what often amount to "scorched-earth" proceedings. The hearing in the instant proceeding is a case in point. Without exception, Ameritech had no fewer than 7-10 attorneys, 2-3 legal assistants, 2-3 subject matter assistants per witness, and nearly a dozen regulatory support staff present in the hearing room throughout the hearing. By any measure, Ameritech likely outspent the CLECs 4:1. Such "overkill" is in all likelihood the result of Ameritech's intention to recoup its expenses on the backs of the CLECs through inflated UNE rates. Because Ameritech's legal and external relations efforts are coordinated principally for the benefit of the firm's shareholders, the expenses associated with those efforts should be borne by the shareholders.

Ameritech's legal and external relations expenses should be removed in their entirety from the shared and common cost pool. The removal of these costs, along with all of the previously recommended adjustments, results in a Wholesale Factor of *** (*See* Tr. Vol. 9, p. 3019 and Vol. 11, p. 4349, Exh. 69.)

II. AMERITECH'S CRITICISM OF THE CLECS' WITNESS IS BASELESS AND DESIGNED TO DIVERT ATTENTION FROM THE FLAWS IN ITS OWN STUDY.

Rather than addressing, let alone correcting, the multiple flaws that Mr. Behounek identified in its shared and common cost study, Ameritech goes out of its way to level unsubstantiated, even personal, attacks on his analysis. The criticism is as unfounded as it is unseemly.

A. Both the Arthur Andersen and New Ameritech Studies are Flawed.

Ameritech's witness Mr. Palmer indicated that Mr. Behounek's "real" objection to Ameritech's new shared and common cost model is the results it generates rather than the methodology employed. (*See* Tr. Vol. 3, p. 825). The simple fact is that these issues are inseparable. Both the methodology and the results are flawed. The previously used Arthur Andersen study and the new Ameritech shared and common cost model are deficient (as are their results), but for different reasons. Ameritech appears to believe that the CLECs should be satisfied with one or the other.

To be sure, there are strengths and weaknesses with each of the two studies. The Andersen model had the attribute of being well documented. In fact, AT&T and other CLECs asked virtually no data requests regarding this model in prior proceedings because they were unnecessary. The detail and support for this model made it possible for Mr. Behounek to identify numerous instances where items were double-counted, misallocated, etc., and Commissions all over the Ameritech region recognized these flaws. (*See* Tr. Vol. 8, p. 2877).

The Andersen model, however, suffered from the fact that it studied only a small portion of Ameritech's operations. That is, the shared and common costs were related only to the unbundling segment of the AIIS business unit, which was incurring significant start-up costs and was nowhere near operating at long-run, efficient levels. At the same time, the unbundling unit was offering a relatively small number of unbundled elements. The net result was that the high start-up costs (as well as all of the misallocated costs) were attracting a high level of shared and common costs and these costs were being divided by the TELRIC of a small number of unbundled elements - all of which caused an overstatement of the forward-looking shared and common costs. Mr. Behounek criticized the Andersen model for the shortcoming mentioned above, stating that the company should be analyzed as a whole (separated between wholesale and retail) for the determination of shared and common costs in order to minimize the effect of the company's new operations. Specifically, the shared and common costs should be analyzed in relation to the TELRIC (or TSLRIC) for all of the company's products.

In other jurisdictions, AT&T has acknowledged that looking at shared and common costs on a larger, company-wide basis was a needed improvement. However, AT&T has consistently made it clear that the new Ameritech model's broadly generalized cost pools, lack of support, and extreme tops-down methodology were serious problems because they left the appropriateness of the cost model's cost allocations effectively un-auditable and unverifiable. AT&T has not and does not offer any support now for Ameritech's model because the problems with this model remain to this day.

In various proceedings, AT&T, and other CLECs, have attempted to correct the flaws in both the Andersen and new Ameritech models. Indeed, Mr. Behounek had the opportunity to review and evaluate the Andersen study extensively in multiple jurisdictions until he possibly knew it better than any of the individuals on the Andersen team. After working with and analyzing the model in detail, he did not recommend that the Commission use the results of that model. (*See* Tr. Vol. 8, p. 2879 - 2880) He has reached the same conclusion here based on a thorough analysis of Ameritech's new model.

Ameritech states that the Commission should look to the shared and common costs used previously in Wisconsin and other states but ignores the Michigan Commission's conclusions regarding Ameritech's shared and common costs. Regarding Wisconsin, the Commission in 1997 did not have the benefit of the in-depth examination of the Andersen shared and common cost study. It is entirely possible that the Commission would have reached a different conclusion if they had the benefit of the additional information. Second, the Michigan Commission has seen both the Andersen study and the new study and has both times adopted a shared and common cost percentage that is nearly the same as the one that Mr. Behounek proposes in this proceeding. The Michigan Commission's decisions deserve special attention for two reasons. First, the Michigan Commission had the advantage of reviewing all of Ameritech's shared and common costs at once. That is, the Michigan Commission comprehensively reviewed shared and common costs for both Ameritech's wholesale and retail services. Second, the Michigan Commission staff was in a position to leverage their analysis of the study with Mr. Behounek's analysis that was underway concurrently.

Further, with regard to the Illinois Commerce Commission proceeding (cited by the Ameritech witness), it is not clear that the ICC adopted any shared and common cost percentage. In fact, the ICC adopted most of Mr. Behounek's proposed changes, but unfortunately was silent on the issue of the unbundled element LRIC base to which the shared and common costs were applied. As Mr. Behounek testified, this was a significantly flawed part of the Andersen study and, interestingly, the part that relied most on Ameritech's input instead of Arthur Andersen's input. Apparently, Ameritech interpreted the Illinois Commission's silence on this issue as acceptance of its position.

Ultimately, it should be noted that, in general, the Commissions in all Ameritech states credited Mr. Behounek for identifying misallocations and related errors in Ameritech's studies. Those Commissions ordered Ameritech to make adjustments and corrections.

B. Ameritech's Comparison of Its Shared and Common Costs to AT&T's is Irrelevant and Unreliable.

There is no company of Ameritech's size and structure with a comparably sized geographic service territory that is currently providing local telecommunications services in an effectively competitive marketplace. If there were, Ameritech's attempts to compare its shared and common cost percentage to a percentage that it imputes for AT&T would be an appropriate comparison for Ameritech's shared and common costs. (*See* Tr. Vol. 8, p. 2882.) As it is, Ameritech's comparison of its operations with the AT&T of 1994 (or any other subsequent year for that matter) is simply not an appropriate comparison. The AT&T financial information for 1994, upon which Ameritech relies, is for a company offering long distance services. This is not the same market in which Ameritech is operating.[9] Ameritech thus engages in an "apples-to-oranges" comparison of limited reliability.

[9] A widely accepted measure used to determine whether two companies operate in the same market is the extent to which the products the companies produce are substitutes for one another. It is obvious that local and long distance services are not substitutes; they may be complements, but they are certainly not substitutes.

Contrary to Ameritech's simplistic comparison, a more relevant analysis would look at the actual structure of the companies' operations. As evidenced by their structures, AT&T and Ameritech are not comparable for purposes of comparing shared and common cost percentages as produced by Ameritech's methodology. The most striking difference, and the one that is fatal to the appropriateness of Ameritech's comparison of shared and common costs, is the difference in investment necessary to serve the customer. According to Ameritech, AT&T's 1994 ARMIS investment totals $21,941,200,000. At the same time, according to the FCC's 1998 Statistics of Common Carriers, Ameritech's total investment for its five-state region equals $30,725,972,000. Therefore, in 1994 AT&T was serving all 50 states with 30.8% less investment then Ameritech needed for only five states in 1998. As evidenced by these figures, the long distance market is less capital intensive then the local exchange market, which is the primary reason why it is inappropriate for the Ameritech witness to use AT&T's data in Ameritech's shared and common cost study.

Moreover, Ameritech witness Mr. Palmer contends in his rebuttal testimony that Ameritech's shared and common cost study "appropriately estimates forward-looking costs by [ ] developing relationships between expenses and investments as of 1998 …" (*See* Tr. Vol. 3, p. 832) That is, in Ameritech's model, shared and common costs are divided by direct costs, that are predominately composed of investment-related costs. Given that AT&T offers services that are far less investment intensive, the results that Ameritech achieves using AT&T's information are not surprising.

There also is no assurance that the underlying AT&T data being used by Ameritech is comparable. The Notes for Table 2.9 of the FCC's 1994 Statistics of Common Carriers states the following regarding the source of the financial information:

SOURCE: ANNUAL ARMIS (AUTOMATED REPORTING MANAGEMENT INFORMATION SYSTEM) USOA REPORTS (FCC REPORT 43-02) OF REPORTING CARRIERS, EXCEPT FOR AT&T COMMUNICATIONS, INC., AND ALASCOM, INC. DATA FOR THESE COMPANIES WERE COMPILED FROM THEIR ANNUAL FORM M REPORTS. [Original capitalization retained.]

If the financial data were compiled in a similar format, it is possible that some comparisons of AT&T's and Ameritech's financial data could be made (but any evaluation of the validity of the comparisons should consider the very real investment differences necessary for the services the two companies provide).

Unlike Ameritech's witness, Mr. Behounek used AT&T in a discrete example to put Ameritech's shared and common costs in proper context. In doing so, Mr. Behounek understood the problems associated with comparing two companies whose capital structures are so different (as discussed above and in Mr. Behounek's testimony). Mr. Behounek's narrow, but compelling, point was that AT&T, in its transition to a competitive environment, had to cut its overhead costs significantly (by 24%) to be efficient and remain competitive. The CLECs can only hope that Ameritech itself will some day make that same transition to competitive markets. As it stands today, however, Ameritech's grossly inflated shared and common costs are a barrier to competition.

C. Ameritech's Comparison of Its Model to CLEC Models in Other Proceedings is Unavailing.

In what amounts to another red herring argument, Ameritech introduces a comparison of Ameritech's shared and common costs with those produced by the Hatfield (HAI) Model in other state proceedings. (*See* Tr. Vol. 3, p. 536 – 538) Unfortunately, as was the case with its comparison to AT&T's financial data, Ameritech looks at only a small piece of the entire story. As a threshold matter, without conducting a detailed analysis of the HAI model it is impossible to determine whether an apples-to-apples comparison is being performed. Moreover, as with the comparison to AT&T's financial data, Ameritech considers only shared and common costs without considering the underlying TELRIC/LRIC costs. The strained analysis never gets off the ground.

For any given pool of costs one can sort the costs between direct, shared, and common costs. However, the distribution of the costs between these cost types will not always be the same for any given pool of costs. The extent of attribution will affect the distribution of the cost pool between direct, shared, and common costs. One attribution method could result in higher direct costs and relatively lower shared and common costs. Another method may be used where there is insufficient information to attribute as many costs to direct costs, the result of which will be relatively higher shared and common costs. The method chosen may rely on the amount of information available, the time and resources spent on the attribution, or the underlying goal of the analysis. (*See* Tr. Vol. 8, p. 2889)

Although it is not clear from Ameritech's comparison, the HAI model may be using ARMIS data that is very highly aggregated. But HAI cannot determine from Ameritech's computer and information management USOA accounts what level of expenses are related to CABS versus other systems, for example. HAI cannot examine

Ameritech's land and building accounts and determine what portion of expenses are attributable to central offices versus corporate buildings. And HAI certainly cannot tell how sales expenses are broken between Ameritech's business units by looking at ARMIS data. This lack of information, among other reasons, helps explain why the HAI model cannot attribute as many costs to direct costs, which in turn helps explain why HAI's common loading factor is larger.

Curiously, Ameritech has not commented on the LRICs that the HAI model produces. It is possible that the individual LRICs could be smaller, fewer, or both. Obviously the LRICs and shared and common costs must be looked at together. Ameritech cannot compare different models and simply extract certain aspects and results that it likes best. A valid comparison of models must take into account all relevant assumptions and inputs. Certainly Ameritech's witness Mr. Piasecki thought so in Case No. U-11831 before the Michigan Commission:

> The shared and common cost study cannot stand alone. It must be carefully developed on a consistent basis with TSLRIC/TELRIC studies.

(*See* Tr. Vol. 8, p. 2890) In sum, the HAI model's shared and common costs cannot be compared in isolation with Ameritech's shared and common costs.

<u>Conclusion</u>

Fundamentally, Ameritech's shared and common cost study, which supports its overhead loading factor to be applied to its TELRIC costs for UNEs, is flawed. It employs a top-down methodology that is in stark contrast, and extremely inferior, to the bottom-up methodology employed in the LRIC studies.

In the LRIC studies, costs are only included if Ameritech demonstrates that the cost item is necessary for the provision of that item. That is, if Ameritech does not specifically demonstrate that the cost item is necessary for the provision of that item, then it is not included. This is as it should be and is completely unlike the methodology employed in Ameritech's shared and common cost study.

Within Ameritech's shared and common cost study Ameritech identifies large pools of aggregated costs (such as USOA accounts) and then makes a cursory attempt to remove costs that are not shared and common. It then provides support limited only to the costs that are not shared and common costs. If the LRIC loop studies were performed in this manner, for example, it would be similar to Ameritech presenting an aggregate pool of costs and then only identifying certain costs that are obviously not related to loops. Obviously, this would result in higher loop costs as parties were left to try to guess all of the costs within the aggregated cost pool that are not loop related.

But that is what occurs in Ameritech's shared and common cost study. The shared and common costs are inflated because the parties will obviously be unable to successfully identify all the costs that are not appropriate as shared and common costs and that are concealed within broad aggregations of costs. If Ameritech were only allowed to include costs that were well-identified and supported as shared and common costs in the shared and common cost pool, the Commission and CLECs would see a more rigorous Ameritech analysis and ultimately a lower overhead percentage. On the other hand, if Ameritech gets to keep all costs in the shared and common cost pool except for those costs that <u>it</u> explicitly identifies as being unrelated to shared and common costs, how much effort will Ameritech exert in order to reduce its shared and common cost pool? The answer is obvious. Ameritech's shared and common cost study must be revised and corrected consistent with the recommendations of Brad Behounek.

The Michigan Public Service Commission concurs with the CLECs' assessment of Ameritech's study:

> The Commission concludes that Ameritech Michigan's shared and common cost study should not be adopted. The model has a theoretical appeal, but without access to detailed underlying data, it is difficult to guard against the double counting of expenses. The methodology includes all costs in specified accounts in the shared and common cost study unless they are specifically excluded. Without ready access to the underlying data, it is also not possible for the parties to verify that Ameritech Michigan has made the appropriate adjustments for one-time expenses and removed costs that should be assigned to a particular service. Without access to the underlying data, it is also not possible to determine whether costs associated with unregulated and regulated services for which Ameritech Michigan did not perform TSLRIC studies are excluded or included by default. Furthermore, by using actual data, Ameritech Michigan assumes that its current operations are as efficient as a forward-looking approach would yield. The Commission does not assume that there are no further improvements that Ameritech Michigan should make to its current operations. In light of the numerous flaws in the offered study and the lack of an alternative study in this docket, Ameritech Michigan shall continue to use the shared and common cost factors approved in the July 14, 1998 order in Case No. U-11280 and the May 11, 1998 order in Case No. U-11635. Ameritech Michigan's attempt to compare its results to AT&T's costs and the results of the HAI model are unpersuasive because it has failed to show that the comparison is meaningful.[10]

[10] Opinion and Order, MPSC Case No. U-11831, pp. 20 – 21 (November 16, 1999).

The shared and common cost factor approved in the July 14, 1998 MPSC order in Case No. U-11280 and the May 11, 1998 order in Case No. U-11635 is nearly identical to Mr. Behounek's final shared and common cost factor recommendation of ***in this proceeding.

In sum, Ameritech has not met its burden of proof regarding its shared and common costs.[11] It has, at best, provided a high-level, generalized study that does not prove the nature and magnitude of its forward-looking shared and common costs. CLEC witness Brad Behounek's adjustments to Ameritech's study are fair, necessary, and well-documented. Mr. Behounek's adjustments and recommended shared and common cost factor of *** should be adopted. (*See* Tr. Vol. 11 p. 4349, Exh. 69).

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[11] The FCC's First Report and Order in CC Docket 96-98 states the following regarding the burden of proof:

> 680. We note that incumbent LECs have greater access to the cost information necessary to calculate the incremental cost of the unbundled elements of the network. Given this asymmetric access to cost data, we find that incumbent LECs must prove to the state commission the nature and magnitude of any forward-looking cost that it seeks to recover in the prices of interconnection and unbundled elements.